August 12, 2009

Dog Days, Part II: Investors Still Reluctant to Buy Into Stormy Distressed Market

With Prices Still In Flux, Many Buyers Won't Go Out On a Limb -- But Some Sellers Are Starting to Become 'More Realistic'

By **Mark Heschmeyer**
August 12, 2009

Steven Aberman, senior acquisition manager for WBS Properties in Boca Raton, FL, has watched the 43-acre lakefront development of Grand Oaks in Avon Park evolve from raw land that sold for $2.5 million three ago into finished lots. The turnkey gated community now consists of 127 lots, with 25 premium lakefront sites featuring unobstructed views of 280-acre Lake Damon in Central Florida. Aberman just bought the property last month.

"We purchased it fully developed, roads completed, water, gas fully completed, a finished paved pool area, and a boat launch after over $2.5 million in improvements was spent by [the] seller. We bought the whole community for $1.4 million," Aberman said.

Aberman's success typifies the current state of distressed investing. It's a game of patience and waiting for the right price. And for many, the waiting game isn't over just yet.

As we reported last week in Part I of "The Dog Days of Distressed Debt," our examination of the distressed investment landscape, falling property values are still one of the biggest drawbacks to raising money for distressed assets. In the same way, buyers and sellers waiting out the storm are also one of the major hurdles to deploying the money raised so far. Both the sell side and buy side of the market are still waiting for a narrowing of pricing expectations -- a process that is only just beginning.

"What may be counterintuitive is that our return expectations are actually rising; we perceive greater risk in the intermediate term. To us, it makes some of the deals that have been done this year a little puzzling from a pricing perspective," said Steven Sandler, CEO of Crosswind Capital in Rye, NY, and a regular Watch List contributor. "Although completed transactions have been scarce these past six months, those deals that have closed bear all the hallmarks of guys trying to catch the falling knife."

"Current commercial owners need to come to grips with the fact that the valuations of eight to 12 months ago are gone," said Thomas D. Kuffler, president of Civic Asset Management in Scottsdale, AZ. "We are continuing to see rents fall and vacancies increase. Our commercial rental market consists of a shuffling of current tenants downsizing and or upgrading into nicer buildings as their leases come due. Owners need to position themselves as best they can to compete with the REO product in terms of rental rates and concessions; which if they are underwater is going to be tough to do."

"As an MAI with over 20 years experience I can tell you that I have not seen anything to come close to how quickly values have dropped," agreed P. Scott Voltz, MAI, MBA Voltz Commercial Realty Advisors in Santa Clarita, CA. "Brokers report that buyers are only waiting for deals."

Pathfinder Partners in San Diego is in the market raising money for its Pathfinder Partners Opportunity Fund II that will invest in both commercial properties and commercial mortgages. Mitch Siegler, senior managing director of Pathfinder Partners, said they are starting to observe some narrowing of the bid/ask gap.

"Certain banks are becoming motivated to sell at more realistic prices," Siegler said. "We looked at 800 potential opportunities in 2008 and made just two investments -- primarily because sellers simply weren't realistic about pricing. We just closed our first deal of 2009 [acquisition of a loan on a finished, detached

residential subdivision] and are under contract to close [in about two weeks] an REO purchase of a new condo project."

Cash is King

To get a deal done in this environment takes a willingness to move quickly and come in with a lot of cash.

"Investors wanting to buy distressed commercial real estate must be able to buy properties as-is, where-is and without any due diligence periods. The days of 60- to 90-day due diligence periods are long gone. When a lender is ready to sell, they want it sold," said Stephen Karbelk, president of National Commercial Auctioneers in Tulsa, OK. "That inherently gives the new distressed funds an advantage. They can come in and buy quickly in an all-cash deal."

That's a phenomenon that has already begun, according to Jay Boyle of the Investment Division Grubb & Ellis|BRE Commercial in San Diego.

"Our team has closed two deals in the last two weeks, with two more in escrow. The two sellers were pension funds that had liquidity events unrelated to that specific property and were part of a larger portfolio-repositioning strategy. The buyers were all cash," Boyle said.

The all-cash buyers can be put into two categories, according Bob Pounds, senior vice president, investment sales at NAI Welsh of Minneapolis/St. Paul.

"One group is looking for the safest real estate they can find, which would be a property that has a long-term lease with a tenant of investment grade credit with a good business model in an 'A' location," Pounds said. "The other group is looking for more risk. They're looking at well-located distressed properties in excellent condition that have a weak rent roll. The intent is to capitalize on the seller's precarious position of either near term debt maturity or the need to reduce long term liabilities."

Getting deals done piecemeal, however, is not the most efficient for the new funds coming in with millions to spend or sellers with huge portfolios of distressed assets.

"I too have been collecting names of CEOs in charge of these funds. They seem to form every day," said Ron Opfer in the Commercial Asset Division at Coldwell Banker Premier Realty in Las Vegas. "I don't see them coming forward to banks individually to buy one off properties, at least not at the banks I work with. My guess is that they are waiting for the private partnership to be more attractive. I spoke with a higher up at the FDIC (Federal Deposit Insurance Corp.). They indicated they are not going to do any more auctions like they did for Silver State Bank in Las Vegas. Several of my clients have properties with the FDIC. They too are being told that there will not be an auction, rather, the properties will be placed in the private partnership pools."

In Ernst & Young LLP's latest survey of distressed investors, the accounting/consulting firm noted that 45% of respondents said they have not yet purchased any distressed assets because they believe it is simply too early in the cycle of distress for them to even attempt to purchase nonperforming loans right now. This strongly suggests that many investors, at least, believe seller "ask" pricing on the few deals that are coming to market is still too high.

So when will the slow momentum of the dog days of distressed investment end?

The Ernst & Young survey noted slightly more than 30% said they believe the market is already witnessing significant default activity. However, the majority (47%) of respondents said they believe that a significant increase in commercial mortgage defaults will begin before the end of the fourth quarter of this year. About 20% are looking to 2010 before major default pressure comes to bear on the market and distressed sales begin in earnest.

Targeted Assets

According to Ernst & Young respondents commercial whole loans are overwhelmingly the primary investment of choice for distressed investors with more than 45% eyeing the asset category. Residential and

land loans were the next most popular categories, each selected by 18% of the respondents as being a preferable investment, followed by residential acquisition and development (A&D) and construction loans at 11%. Commercial and residential mortgage-backed securities (CMBS/RMBS) and loans backed by hotel assets each attracted less than 10% of respondents.

"The key for most investors is transparency and having enough good information to make an educated offer. Whole loans are relatively easy for most investors to quickly get their arms around which may be one hint of their attraction to respondents," explained Chris Seyfarth, Ernst & Young LLP's National Director of Nonperforming Loan Services, and the report's author.

Seyfarth suggests that this presents the potential for a deep, highly competitive market in the near term -- and this could impact pricing and execution quite heavily from the outset.

On the plus side for sellers, E&Y's survey indicates that investors' return expectations are not unreasonable. "Only 35% of those investors polled claim to have return requirements above 20% and an equal number actually are shooting for returns in the 10% to 15% range," said Seyfarth. The balance of investors sit in the 16% to 20% range, suggesting that the spread between bid and ask pricing may narrow quite quickly once deals begin to flow to the market.

CoStar Group Watch List readers also weighed in on the topic. The following are excerpts of comments and insights from wide sample of real estate executives across the country on the state the distressed investments. The comments are broken out by asset type.

Debt Is Really Income, with the Potential To Become Property

Mortgage pricing substantially favors multifamily assets as debt is still available at 6% or less for higher leveraged the assets via the agencies [Fannie Mae, Freddie Mac]. Conversely, commercial properties are financed at levels of 60% of value or less with strict cash-out requirements and other provisions (e.g., recourse) previously thought too onerous as lenders cherry-pick deals.

With distressed debt deals offering very appealing rates and principal reduction, astute investors redouble efforts in this investment arena. "Loan to own" opportunities appeal to such buyers, especially those with development and management expertise. Banks and other distressed financial institutions provide an ongoing pipeline of deals.

More market clarity is expected in the fall when investors return from the summer holidays. For now, most institutions consider asset management as their top priority." He suggests, "Many legacy owners are more concerned about losing income stream rather than capturing new opportunity plays.
Gary Duff, advisory board member of the Real Estate Capital Institute in Chicago

---

We are contacted daily by groups that have raised money, so I agree with you in that a flood of buyers seem to be positioning themselves. Many are not necessarily doing things as a true "fund". There seems to be a large amount of groups / companies that have been able to put together a decent amount of capital in order to have buying power in the $50 million to $300 million range. This capital will be spread out over many different transactions. This will certainly make them competitive for what lies ahead.

In my view, the smaller groups will be able to execute just as well as the large fund buyers due to the fact that there seems to be a lot of fragmentation in the market right now. Sellers are selectively putting deals out. We don't really see the large pools that can only being offered to a handful of groups due to size / capability to take down a $500 million or even $1 billion pool.

Additionally, once these large pools are put together and sold (most likely seller being the FDIC), these smaller groups will be able to selectively buy loans out from the winning buyers as they seek to dispose of the assets.

We are seeing the large majority of interest in sub-performing and nonperforming loans. Most buyers are looking for "units" that can be leased or sold. Land is of limited interest. Broken condo deals are a sought after property type. Many buyers want to rent them out and then sell in a few years when prices recover. Most of these buyers will look at loans and REO since they are mainly interested in the real estate.
Barry C. Smith, President LoanSaleCorp.com in Scottsdale, AZ

Main street investors seem to be more interested in distressed debt and property funds as opposed to distressed securities because of the fear of inflation.
Dawn Campbell, Vice President of Welsh Securities in Minneapolis/St. Paul

TALF Opportunities

TALF-eligible [Term Asset Backed Securities Loan Facility] securities are creating a whole new investment opportunity for income-focused investors. With the Fed providing substantial leverage to investors of highly rated asset-backed securities eligible to be financed through the TALF program, we believe a carefully executed strategy may yield attractive returns.
Joseph Gargan, senior managing director, and of Mesirow Financial in Chicago

Commercial Real Estate Property is a Contrarian Play

We are contrarian investors. We did low leverage value play investing in the late '90s while everyone else was chasing leveraged income (yield) deals. We stopped buying in 2005. We have now shifted our strategy to flight to quality investing in income (yield) with an upside on the back end from capital appreciation. Distressed asset investing is value play investing. In order to harvest value, you must be in a position to generate income (yield) at low leverage (strong capital/debt ratio). In order to generate income, you must have long term tenant leases with strong credit quality tenants. These tenants are few and far between today. They are typically shrinking their footprint (cutting costs), not expanding. When their existing leases roll over they are staying put. They are not relocating because of the cost of relocation.

Many of the survivors in our industry are chasing the same chimera, the ghost of the RTC past. This economic recovery will not mirror the 90's. It is a jobless recovery. We are in the process of purchasing a 25 year old class B+ office building in a Class A+ location. We will purchase the building for 60% of replacement cost. It is 100% leased to a single tenant. The yield will exceed 10% cash on cash (with a high equity to debt ratio) from day one and rise to 15% cash on cash in year five from the existing Tenant base that has strong credit quality. This will be our first purchase in almost 5 years.

The great unknown remains the exit scenario for real estate investors. Without a long term permanent financing market, the exit strategies are very limited. We enjoy reading your reports and articles.
Floyd Shechter, President of SmartSpace LLC in Nashville, TN

Capital is more readily available for well-located and leased multifamily, industrial and office properties, but is increasingly difficult to secure for retail and hotel properties. Commercial banks are lending to new owners of distressed real estate, but they oftentimes require that the asset be repositioned, re-leased or rehabbed. Experienced, credit-worthy borrowers who are capable of creating and executing a solid business plan that the banks believe in will have a better chance of finding financing than those without a solid business plan.
Peter Austin, Senior Vice President of Welsh Capital in Minneapolis/St. Paul.

We have an appetite for the assets listed below, pretty much unchanged for the past year. However, I would note two things: our investors are becoming more active (writing checks) as opposed to merely be very interested; and there is a little more product available for sale ("little" is the operative word here). Our investors are family offices and sovereign wealth funds from the Middle East, Asia, Canada and the U.S.

We recognize two kinds of distress, operating and financing. Financing can be property specific or related to larger, corporate issues.

Appetite today:
We seek prime Class A office in LA, Manhattan, San Francisco, Boston and Washington DC. We do not buy office properties with operating distress, only financing distress.
We seek apartments located near college campus from Texas eastward. We buy multi- family with operating or financial distress.
We buy select tranches of CMBS.
We buy performing, whole loans in all top 20 metros.
Charles G. Cecil, Partner of Opin Partners LLC in New York, NY

There are however a number of Class C multifamily properties that are experiencing troubles and high vacancy, which drags the overall market numbers down. These almost all have one of the following problems, sponsorship problems, been foreclosed and being run by the servicer, or are being run by a court-appointed receiver as the results of loan defaults. In these instances the properties stagnate and don't have access to the necessary funds to operate and maintain the property and the occupancy begins to slide and continues that way until they get a motivated owner to operate them.

For financing on C deals the only option at this time is HUD loans. The Bs can still get Fannie Mae financing but not the Cs. Very few sales transactions are closing primarily due to the lack of financing. The equity dollars seem to be there. Lots of properties are going under contract but unless they involve some type of seller financing, they aren't closing. The properties that are selling all have a common theme, they have a very high vacancy, operating negatives and are being sold for deeply discounted prices.

The properties with low vacancy and good cash flows which could be sold in normal financing time are just not selling. Sellers know they have value and have no need to discount a deal just to get it closed.

CMBS maturities will creep into the mix at some point but we haven't really seen that yet. The only acquisitions we have done in the last year were situations where we took over properties for nothing down and assumed the loans. The only upfront capital necessary is for deferred maintenance cost and lease up costs.
Ruel Hamilton, Principal of AmeriSouth Realty Group in Houston, TX

Our town was impacted only in a minor way by the recession until the second quarter of 2009 when move-outs doubled in our 2,300 unit Class C portfolio. People are losing income and doubling up or downsizing. No financing is available much above the $3 million available from local commercial banks. Big banks, despite TARP help, are being pressured by the FDIC to tighten underwriting. Completely at odds with the public talk by politicians. Fannie & Freddie say business is as usual, but that's not close to reality.

Landlords are falling into the tried and true money loosing strategies of concessions and discounts in the face of rising utilities, insurance & taxes. The downward spiral is well underway - that fancy term today is de-leveraging.
Glen Ruffner, Asset Manager of The Falls Apartment Group in Houston

---

During the first half of the year, we have seen a new record low in terms of number of sales, down 81% in dollar volume and 64% in transaction volume. At the same time we now have a record number of hotels in California that are on the market (over 940, which is up 54% in the last six months alone). At the current sales pace we now have a 10-year supply of hotels for sale, or 22 hotels on market for everyone that sells.

In addition we are seeing the number of distress assets skyrocketing with over 250 hotels either in default or REO. What we are advising our seller's is that they need to price their assets accordingly or they are simply not going to sell. Buyer's have to be ready and able to move quickly when the assets do get re-priced as there is a lot of competition waiting on the sidelines.

We expect this to change in the first quarter of 2010 as more lender deals hit the market.
Alan X. Reay, President of Atlas Hospitality Group in Irvine, CA

Residential Land Being Deep Discounted

For the first half of 2009, land sale activity in Georgia has been minimal at best. I utilize CoStar COMPs heavily and for the entire metro Atlanta region (more than 5 million people) I am only getting one or two CoStar alerts per week for land sales. The mix seems to be about one-half end user sales and one-half distressed sales with speculative buyers. Other than residential subdivision lot sales, we are not yet seeing a wholesale purging of distressed properties particularly in either commercial land or distressed office or retail. From a purchasers perspective, the only active purchasers in the metro Atlanta area are fast food, low price point retailers (dollar stores), and the two large fuel centers in this market (Quik Trip and Racetrac). The independent fuel centers are not active at all because they cannot get any financing for deals and their margins are small to begin with. There are some medical users (dentists, doctors) purchasing land or buildings for their practice.
Tim Knight, Partner of TriVest Real Estate LLC in Atlanta

August 12, 2009

I believe paralysis - paralysis - paralysis best describes my experience over the past 18 months in the fully developed bulk residential market. Tough to get in the door of the large residential mortgage servicers that have sold tapes unless you want to buy in less desirable markets. Smaller lenders/sellers either cannot or will not discount there REO's sufficiently to meet buyers models. Capital constraints in the banking sector will not allow many lenders to discount to the extent necessary to meet buyer's requirements.

On the bright side, I am aware of a buy of 200+ single-family homes at 55 cents on the dollar from current market value. A good portion of these homes have been sold and with home sales increasing in the U.S., perhaps this program and others like it will be successful.
Thomas C. Kelly, Principal of Orchard Hill Associates LLC in Minneapolis/St. Paul

---

Hedge funds appear to have placed the first deeply discounted cash deals in play. Real estate professionals are spreading their equity around and some of the smaller regional banks finance the REO sales in-house. The appetite for distressed properties appears to range from robust to voracious. Brokering loan portfolios appears to be a cottage industry doing brisk business. REO brokers are the industry du jour.

Planned residential subdivisions with expired permits can only be classified as raw land. On this basis they are being transacted with deep discounts based on updated and downgraded appraisals with loan write downs. These are highly speculative, location sensitive assets and should be carefully screened and positioned as long term "land banks" for future development and/or sale with activated permits. They are largely discount cash transactions.
Rachel Maman, Principal Broker of Boston Investment Realty in Newton, MA